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The Philippines: Growing Financial Strains

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An Intelligence Assessment

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EA 83-10064
April 1983

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The Philippines: Growing Financial Strains [redacted] 25X1

An Intelligence Assessment

This assessment was prepared by [redacted] 25X1
Office of East Asian Analysis. Comments and queries are welcome and may be directed to the Chief, Southeast Asia Division, OEA, [redacted] 25X1

This paper was coordinated with the National Intelligence Council. [redacted] 25X1

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The Philippines: Growing Financial Strains [redacted] 25X1

Key Judgments

Information available as of 21 March 1983 was used in this report.

We believe there is a high risk that the Philippines will experience serious foreign debt repayment problems in the next two years. According to the International Monetary Fund, last year's current account deficit of $3.3 billion—a record 9 percent of GNP—is three times the level sustainable. A repeat of this performance would almost certainly require a rescheduling of the country's foreign debt repayment obligations because of the already heavy debt service burden. [redacted] 25X1

Several measures would enable Manila to buy some time and avoid a foreign exchange crunch during 1983. Debt service obligations of $3.2 billion will be manageable this year if the government follows up on plans to exercise financial discipline. Reserves are also probably sufficient to cushion the effects of refusals by smaller US and West European banks to roll over existing short-term obligations—a process we now see occurring for the first time. However, running down reserves largely avoids necessary financial adjustment measures, and in our judgment would almost certainly produce a repayments crisis in 1984, when National Assembly elections will be President Marcos's overriding concern. [redacted] 25X1

If a financial crisis occurs, we believe it will start in the private sector. Many large corporations are vulnerable because of the domestic business slowdown and their own mounting foreign debt service obligations. Unfortunately for Manila, the decisive actions necessary to ease balance-of-payments strains—rapid exchange-rate depreciation and slow economic growth—will make the private sector even weaker over the short run. Manila, however, has little choice but to take these actions, hoping that the private sector's financial problems do not become so unmanageable that rescheduling the sector's entire foreign debt becomes necessary. Over the longer term, Manila faces the need to restructure the economy if balance-of-payments considerations are to allow the country to resume the 6-percent annual real growth that Filipinos grew accustomed to during the mid-1970s. [redacted] 25X1

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The Philippines: Growing Financial Strains [1]

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Financial Developments in 1981-82

After surviving slowing growth, rising unemployment, and the near collapse of domestic financial markets in 1981, the Philippines last year posted its worst balance-of-payments performance ever. The current account deficit ballooned to $3.3 billion—a record 9 percent of GNP—at the same time that net direct foreign investment inflows dropped by half and the Central Bank reduced sales of domestically produced gold. As a result, financing the deficit required that the volume of new foreign loans grow by nearly $300 million in a year when government technocrats insisted it was imperative to reduce the level of borrowing. What is worse, by yearend the Central Bank ran down international reserves to $1.7 billion, which equaled 10 percent of the foreign debt, down from 22 percent at the end of 1980 (table 1).

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Controversy over government national accounting data and Central Bank foreign debt figures, coupled with friction with both the IMF and the World Bank over the conduct of economic policy, made a terrible year even more painful for government policymakers. Government financial and trade data placed the total foreign debt at yearend 1982 at $17.2 billion—about 55 percent higher than at the end of 1980 (figure 1). Estimates by private consulting firms place the debt as high as $18.5 billion, however. Our own methodology places the debt at about $18.8 billion—about 50 percent of GNP. By this standard, the Philippines is now in the same league as Brazil, Mexico, Venezuela, and Argentina, although safely below the level of Chile.[2]

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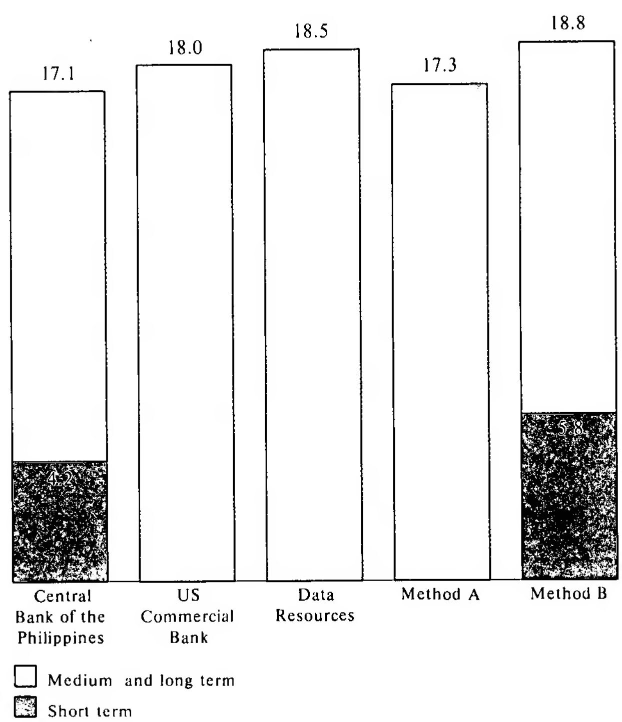
Figure 1
The Philippines: Alternative Estimates of the Foreign Debt

Billion US $ (yearend 1982)



Method A–Cumulative sum of the current account deficit, additions to reserves, and errors and omissions, less direct foreign investment since 1975, plus official estimates of the foreign debt at the end of 1975–$3.8 billion.

Method B–Medium- and long-term foreign debt as reported by the Central Bank, plus short-term claims against the Philippines as reported by the Bank for International Settlements, less $2 billion in double-counting errors and offshore bank lending to foreigners.

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[2] We estimate that at yearend 1982, foreign debt obligations as a share of GNP were 29 percent in Brazil, 49 in Mexico, 41 in Argentina, 46 in Venezuela, and 75 in Chile. The Philippines's repayment schedule is more manageable, however, and thus its international credit rating is superior.

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Table 1
The Philippines: Balance-of-Payments Summary

Million US $

	1976	1977	1978	1979	1980	1981 [a]	1982 [a]	1983 [b]
Current account	−1,101	−828	−1,172	−1,576	−2,072	−2,589	−3,347	−3,100
Trade balance	−1,113	−840	−1,307	−1,541	−1,939	−2,667	−2,805	−2,450
Exports f.o.b.	2,519	3,075	3,425	4,601	5,788	5,733	4,995	5,500
Of which:								
Coconut products	537	729	812	965	759	756	647	700
Sugar	451	527	213	238	474	609	324	325
Copper concentrates	270	280	250	330	679	544	340	500
Forest products	268	261	324	484	433	383	340	400
Manufactures	573	770	1,076	1,520	1,135	1,294	1,050	1,245
Imports f.o.b	3,632	3,915	4,732	6,142	7,727	8,400	7,800	7,950
Oil	936	1,019	1,030	1,385	2,248	2,458	2,396	2,190
Others	2,696	2,896	3,702	4,757	5,479	5,942	5,404	5,760
Services (net)	−257	−248	−178	−390	−555	−392	−992	−1,000
Interest payments	−258	−302	−440	−591	−846	−1,101	−1,811	−1,900
Others	1	54	262	201	291	709	819	900
Transfers (net)	269	260	313	355	422	470	450	350
Capital account	1,151	985	1,162	997	1,720	2,029	2,212	2,600
Of which:								
Direct investment (net)	144	216	171	99	49	407	259	300
Medium and long term (net)	1,014	859	908	1,061	1,044	1,185	1,252	1,600
Short term (net)	−87	−90	83	−193	446	437	423	400
Balance	50	157	−10	−579	−352	−560	−1,135	−500

[a] Estimated.
[b] Projected.
[c] Includes errors and omissions.

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The Old Problems

The Philippines's balance-of-payments problems, for the most part, are an outgrowth of adverse price developments in international markets over the last decade. The terms of trade—the ratio of export prices to import prices—have slipped 33 percent over the last four years to the lowest point of the postwar period. This means that Philippine exports are worth about a third fewer goods in international trade than they were four years ago (figure 2).

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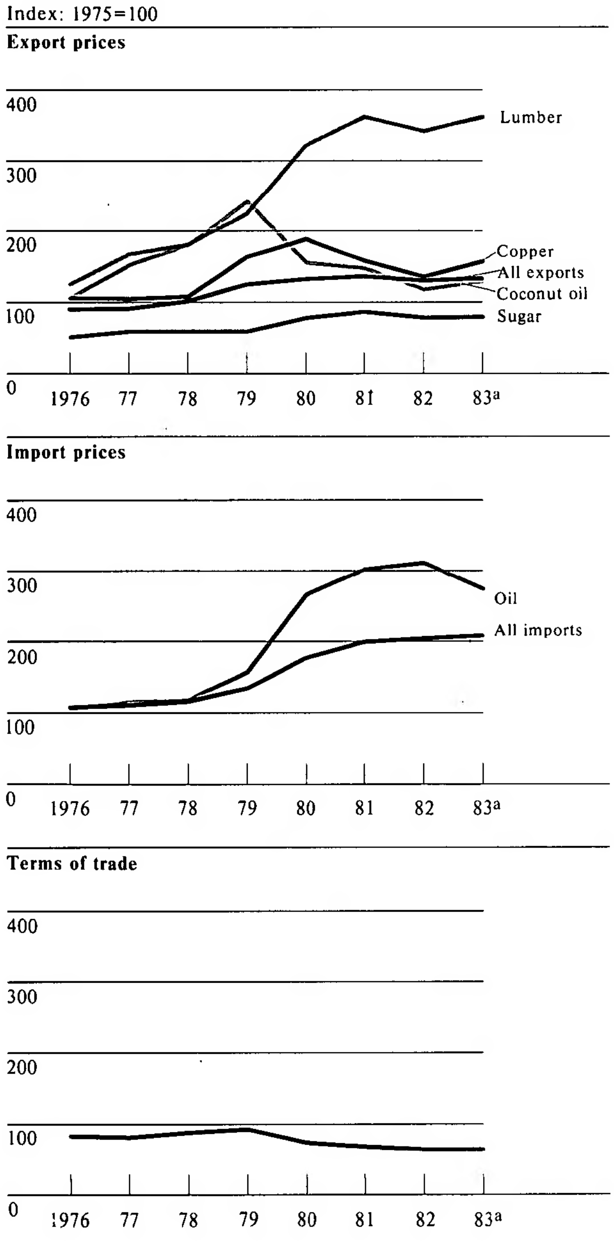
Part of the decline is cyclical; export prices have slumped because of the recession. Last year, for example, the terms of trade declined by 8 percent. More serious from a balance-of-payments perspective, in our judgment, are permanent changes in the prices of several key internationally traded goods, notably imported petroleum. Even with current weak oil prices, for example, Saudi crude oil now sells for about three times as much as it did in 1975. The 1975

Figure 2
The Philippines: Terms of Trade Developments



[a] Projected.

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level, in turn, was about five times the level of 1972. As for exports, prices of sugar and coconut are very low, partly because of increasing industrial use of high-fructose corn sweeteners and new competition from other LDC producers of edible oils. Coconut oil, sugar, and crude petroleum account for about 26 percent of the Philippines's total foreign trade turnover. 25X1

The New Problems

The source of 1982's burgeoning financing requirements represents a historic watershed in the Philippines's external accounts. In previous years, OPEC price hikes swelled the oil-import bill by nearly $1 billion, ballooning the trade deficit even as rising remittances from workers in the Middle East buoyed the service and transfer account. Last year, in contrast, oil imports were down in both value and volume as the recession slowed demand, new geothermal fields began production, and the government oil company drew down inventories. However, this accomplishment was more than offset as repayment obligations on the foreign debt, itself the cumulative result of previous oil import–based foreign trade deficits, increased the service account deficit by $600 million. As interest payments grew sharply, medium- and long-term principal payments in 1982 grew by over $200 million as a result of the shortening term structure of the debt. 25X1

Controversy over the actual size of the short-term debt first arose in the international financial community early in 1982, and agreement continues to elude both the Central Bank and private analysts. International short-term claims against the Philippines rose to nearly $6.9 billion in mid-1982, according to Bank for International Settlements data, and this is nearly twice the government's June figure of $3.6 billion.[3] Even if the Central Bank figures are accurate, however, the short-term debt is now three times the level of

[3] The BIS data include double counting errors and foreign debts covered by foreign assets, but also exclude several categories of legitimate short-term debt, such as claims against the Philippines by banks that are not members of the BIS reporting system and supplier loans. Philippine Government data, on the other hand, exclude short-term obligations by domestic financial institutions relent to the government and private firms. Much of this relending is on a medium- and long-term basis, so that much of the risk is borne by the domestic financial institution extending the credit. 25X1

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the Central Bank's international reserves. Furthermore, we believe that the Philippines's gross financial requirements, including repayment obligations on medium- and long-term foreign loans, renewals of outstanding short-term credits, and the trade deficit itself, reached nearly $9 billion last year, representing a $1 billion increase from 1981. [redacted]

Financial strains have been accompanied by a slide in international creditworthiness now common to heavily indebted LDCs. [redacted] the Philippines's credit rating also has been adversely affected by Manila's unwillingness to accede to new IMF and World Bank demands on domestic economic policy during negotiations that were stalemated throughout most of 1982. Short-term Philippine credits on average now carry a full percentage-point spread over the London Interbank Offered Rate (LIBOR), [redacted] up nearly 1 percentage point from last year. Furthermore, the Central Bank's first syndication of 1983—a $300 million credit with a maturity of eight years signed in early February—for the first time required a tranche based on the US prime rate. Because the US prime rate exceeds Eurodollar rates, the loan will carry an interest rate spread initially equal to 1.625 percentage points over LIBOR, the highest spread the Central Bank ever has contracted. [redacted]

The Near-Term Financial Outlook

External Factors. On balance, we believe the Philippines's financial problems will be only slightly eased by international economic recovery this year. Philippine Government agencies and the US Embassy calculate on the basis of studies of previous business cycles that six months will be required for the benefits of economic recovery in industrial economies to be felt in the Philippines, through higher prices for industrial raw materials and agricultural products. Even the Philippine commercial press reports that most businessmen have already written off 1983. [redacted]

At the same time, we believe that the service account is almost certain to continue to deteriorate. Even as international interest rates decline, our calculations show that interest payments on the medium- and long-term foreign debt will rise by at least $140 million because of the higher level of outstanding foreign debt, while principal repayments on the debt will rise by about $300 million. Philippine press reporting suggests that Manila itself believes remittances from overseas workers have seen their peak with the construction slowdown in Saudi Arabia and an increasing Saudi disenchantment with Philippine workers. [redacted]

Of greater potential short-run consequence is the beginning of refusals among small US and West European banks to roll over existing short-term credit obligations. US banking sources indicate that the largest US banks, which hold about 40 percent of the Philippine external commercial debt, are aware of this problem and increasingly concerned about it. The mystery surrounding the actual size of the short-term debt makes this potentially a far more serious problem than official data suggest. Nonetheless, we believe that the exposure of the small banks is sufficiently small that the Central Bank could continue drawing down reserves to prevent a foreign exchange crisis. In our judgment, however, this would leave the Central Bank in a very weak position by early 1984, unable to intervene further to defend the peso because of low reserves. [redacted] 25X1

On the plus side, we expect international commodity price developments to halt the four-year slide in the terms of trade by yearend. Firmed up copper prices would reduce financial strains in the mining industry, for example. We expect weak international oil prices to allow the government to cut the imported oil bill for the second consecutive year, although it also faces the need to rebuild inventories. An appreciating yen may bolster Japanese imports of Philippine mineral and agricultural products. [redacted]

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The Philippines's external accounts will be helped further by new loan agreements with the Fund and the World Bank. Manila obtained a 12-month $347 million IMF standby loan in February, a $208 million credit from the Fund's Compensatory Financing Facility to replace the shortfall in export earnings, and resumed negotiating a $300 million Structural Adjustment Loan from the World Bank. As in the past, the Fund's program will require limits on foreign borrowing, domestic credit creation, and Central Bank credit to the public sector. [redacted]

Economic Management Options. The IMF, however, has left Manila no margin for error in trimming the current account deficit by requiring that it implement appropriate adjustment policies. Although Manila's record of implementing specific reforms mandated by the IMF and World Bank is good, disbursement of most of the IMF loan will be held in abeyance pending a comprehensive late 1983 review of Philippine budgetary performance, exchange rate management, interest rate policy, external borrowing activity, and efforts to curtail the growth of the short-term debt. The World Bank loan will require reform of energy pricing, further liberalization of trade policy, and a long-promised streamlining of foreign investment regulations. [redacted]

All of the measures required to stabilize the balance of payments carry a potentially heavy political price that Manila has no choice but to pay. Reducing the overall payments deficit means rapid exchange rate depreciation in accordance with the IMF's wishes, and thus higher domestic prices. Reducing financial support to the private sector as a means of reducing the budget deficit—a move also pledged to official creditors—will produce new corporate bankruptcies and, coupled with reduced investment in state enterprises, higher unemployment. [redacted]

Marcos's political agenda could be decisive in determining the timing of the actions Manila takes to avert more serious financial problems than it faces already. [redacted] Marcos will almost certainly want to avoid more unemployment, slowing growth, and accelerating inflation in 1984—when he faces the first National Assembly elections since he dismantled martial law two years ago. Amid recurring charges by his political opponents that he has mortgaged the Philippines's future to multinational corporations and foreign bankers, Marcos will also want to avoid a rescheduling of the foreign debt over the next year. [redacted]

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Accordingly, Manila has already implemented sharp cutbacks in capital spending and Prime Minister Virata has announced a ceiling of $2 billion on new foreign loans for 1983. The Central Bank is also moving to curtail the expansion of short-term debt by announcing new restrictions on foreign loan applications of less than one-year maturity. Furthermore, in a move that according to US Embassy officials surprised both the business community and the country's official creditors, Manila is placing a 3-percent duty on most categories of imports, introducing a prepayment system of import duties designed to ensure customs collections and make import financing more expensive, and implementing a lottery system designed to channel more remittances from overseas workers through the government banking system.[5] [redacted]

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We believe, however, that these moves alone are not sufficient to assure that the Philippines can meet its international financial obligations over the next two years—even with a recovery in the international economy. As matters now stand, Manila would have to exceed either its own ceiling on new medium- and long-term foreign loans or—what is more likely in our view—violate the IMF's ceiling on short-term borrowings to get by. Additional breathing room would be created if Manila took stronger measures to trim the trade deficit, notably suitable exchange rate depreciation during the next two years. This will be the key to averting repayments crisis and the critical step toward capitalizing on any upturn in industrialized economies beyond 1983 (table 2). [redacted]

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[redacted]

[5] The new import duties run counter to the spirit if not the letter of the coordinated program of tariff reductions and foreign exchange deregulation pledged to the IMF and the World Bank. We believe that they will not jeopardize further balance-of-payments loans, however. [redacted]

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Deviations From the Baseline Assessment

We believe that Manila will walk a tightrope managing the balance of payments during the next year, and—with luck—it may scrape by without a foreign exchange crisis. Various international and domestic economic developments could change this baseline assessment, however. [redacted]

On the positive side, there is evidence of a recovery in industrial economies that—coupled with financial discipline by Manila—could ease the Philippines's external payments strains considerably by 1984. International prices for industrial raw materials, including copper, have firmed somewhat during the past several months, although inventories in industrial countries remain large. The Philippines also has the capacity to sharply boost the output of some raw material products, including timber, to take advantage of any rise in export demand. On balance, we believe that a strong recovery in industrial economies would provide the Philippines with windfall annual export earnings of $450-600 million by 1984. [redacted]

At the same time, OPEC remains in disarray, and we believe that international oil prices are unlikely to firm immediately. Because Manila imports about 200,000 barrels per day of oil, mostly from Saudi Arabia, the OPEC price reductions will provide considerable balance-of-payments relief. We estimate that this could reach about $350 million over the next 12 months if Saudi Arabia's benchmark price stabilizes at $29 per barrel. [redacted]

Further easing of international interest rates would provide similar relief. We estimate that each reduction of 1 percentage point in LIBOR reduces the Philippines's interest repayment obligations by about $95 million when foreign debt obligations of all maturities are considered. Thus, an international interest rate reduction of 4 percentage points would outweigh even the effects of lower oil prices. [redacted] 25X1

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In our judgment, however, it is unlikely that OPEC price reductions, global declines in real interest rates, and a strong recovery in industrial economies could coexist for very long. Sustained recovery in the industrial economies, when it occurs, will tighten both the international oil market and international credit markets. Furthermore, Japan, rather than the United States, is the Philippines's leading market for raw material exports, and its economic rebound normally lags behind that of the United States. Thus, it is possible that the Philippines would benefit only marginally over the next 12 months from even an immediate economic recovery in the United States. [redacted] 25X1

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With continued sluggish domestic growth on the horizon, we believe it is almost certain that private Philippine firms will bear the initial burden of balance-of-payments adjustment. As it is, several large firms already have begun rescheduling negotiations with their creditors. The government also has been active bailing out financially weak firms since early 1981. The government-owned Development Bank of the Philippines, for example, has a loan portfolio of about $4 billion, of which it has classified $3 billion as aid to distressed firms. Dramatically increased private-sector financial distress would thus quickly involve the government. [redacted] 25X1

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Looking Further Ahead

Even though we are confident that a recovery of some commodity export prices will occur during the next year, Manila still faces the need to restructure the economy, thereby alleviating fundamental balance-of-payments problems attributable to an uncompetitive manufacturing sector and changes in the international petroleum, sugar, and coconut oil components of the terms of trade. The Philippines's official creditors recognized the need for this in 1979 when the IMF negotiated the first of a series of credits intended to facilitate Manila's gradual adjustment to higher oil prices and the World Bank committed up to $650 million over five years in the form of a "structural

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Corporate financial problems probably have not peaked, in our judgment. Most Philippine industrial firms buy raw materials in the international market and carry foreign debts denominated in US dollars, but sell their products for pesos in the domestic market. As the peso depreciates over the next year, as we believe it is certain to do, corporate cash flow positions will deteriorate further. [redacted] 25X1

The greatest danger, in our judgment, is that the extent of the private sector's financial distress—which we believe Manila cannot gauge precisely—is already so severe that a private-sector financial crisis cannot be avoided. If so, corporate bankruptcies and new requests to the government for financial assistance over the next year would grow beyond Manila's financial management capacity. In our judgment, there is ample reason to fear this, given the poor state of the government budget and the fact that the technocrats are having difficulty coping with even the private sector's present difficulties. [redacted] 25X1

Short-term financing problems could also be exacerbated in the aftermath of the continuing foreign debt crisis in several Latin American countries. A refusal by a growing number of small US regional and West European banks to roll over existing credit lines to the Philippines, especially to the private sector, could provoke the very liquidity crisis that commerical bankers fear. [redacted] 25X1

adjustment" program, which requires reform of industrial policies and the development of labor-intensive export manufacturing. If the coordinated program succeeds, it will largely mitigate the effects on the balance of payments of higher oil prices and weak international agricultural prices. [redacted] 25X1

Table 2
Philippines:
The Debt Service Outlook

Million US $
(except where noted)

	1980	1981	1982	1983 [a]	1984 [a]
Total debt service	**1,624**	**2,245**	**2,833**	**3,193**	**3,566**
Medium- and long-term debt service [b]	1,260	1,652	2,313	2,732	3,105
Amortization	651	799	1,022	1,300	1,535
Interest [c]	609	853	1,291	1,432	1,570
Outstanding medium- and long-term foreign debt	8,550	10,050	12,959	15,759	18,259
Implied average maturity (*years*)	13.2	13.2	11.2	10.0	9.7
Official short-term debt	2,548	3,567	4,162	4,662	4,662
Interest service on short-term debt [d]	364	593	520	461	461

[a] Projected. Assumes current account deficit of $3.1 billion in 1983 and $2.5 billion in 1984.
[b] Including obligations to the IMF.
[c] Assumes six-month LIBOR of 10 percent. We estimate that each 1-percent drop in LIBOR would have the following impact on medium- and long-term interest service: in 1983, $57 million, in 1984, $68 million.
[d] Calculated on the basis of six-month LIBOR.

[redacted] 25X1

The process of adjustment will be painful, however, and to complete it, the Philippines must sharply boost the share of GNP it exports if it hopes to repay financial obligations incurred during the late 1970s and early 1980s. At a minimum, this will entail prolonged exchange rate depreciation, and thus inflation rates that will probably exceed 15 percent annually even with low international inflation and tight domestic money policies. On paper, Marcos, the IMF, and the World Bank have a plan that will eventually steer the Philippines back to balance-of-payments stability. But we believe at least several years will be required before balance-of-payments strains ease sufficiently to allow a resumption of the 5- to 6-percent annual real growth that the Philippines posted in the mid-1970s. This, in turn, does not bode well for 25X1

The Terms of Trade and Foreign Borrowing

Had the terms of trade developments of the last decade been entirely cyclical, Manila could have avoided slowing economic growth (as a way of curtailing imports) by running down its foreign exchange reserves when economic activity in industrial countries contracted and replenishing reserves during subsequent international business expansions. We believe the Central Bank failed to appreciate the fundamental nature of the international commodity price developments, however, and the exchange rate has been overvalued during the last 10 years, thus promoting imports and discouraging exports. This has meant that as terms of trade deteriorated the Philippines financed imports not by increasing exports, but by increasing foreign borrowing—in effect pledging to trim the trade deficit later, when the debt would be repaid. Although adverse terms of trade developments have been beyond Manila's control, in our judgment Manila has implemented adjustment measures too slowly, promoting expansion of both the foreign debt and debt repayment obligations. This in turn accounts for much of the Philippines's current financial distress. [redacted]

prospects for political stability in the mid-1980s, when, among other things, the World Bank projects that labor force growth will reach 3.7 percent annually—Asia's highest. [redacted]

US Interests. The United States has many reasons to monitor Manila's success in managing the balance of payments during the next few years. As a result of previous current account financing, Philippine borrowers now owe US banks roughly $6 billion in debts of all maturities. Bilateral trade exceeds $3 billion annually, and the Philippines is a traditionally strong market for US capital goods. Furthermore, US investors have a $1 billion equity stake in the Philippine economy. [redacted]

[redacted]

[redacted] US Embassy officials believe that economic factors are the root cause of the recent growth of the Communist insurgency, especially in coconut- and sugar-growing areas of the countryside. [redacted]

[redacted]

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